

Global Markets Overview

Asset Research Team

March 2021

Key developments to watch

Biden's \$1.9tn spending package was passed by the Senate; US nominal bonds have risen, reflecting improved expectations for US growth and inflation

- At the time of writing, US 10-year nominal bond yields have risen by c.70bps since the start of the year
- The market expectation of a first US rate hike has shifted from the end of 2023 to the end of 2022
- While investors are expecting a slightly quicker pace of policy rate increases, the main reasons for rising bond yields have been: (1) the risk premium demanded by investors to hold government bonds has risen materially; and (2) expectations for future inflation have been rising
- Nevertheless, the Fed has maintained an accommodative tone: bond purchases will continue over the foreseeable future with no change in forward guidance on their first rate hike

Rising US nominal bond yields have been driven primarily by increasing breakeven inflation rates rather than real yields



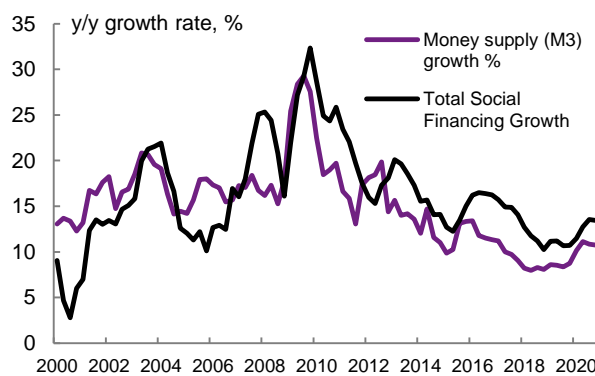
Source: FactSet, Willis Towers Watson

What are the key market-related themes we think investors should focus on to position themselves for success during 2021 and beyond?

Helping you to monitor macro changes

- We think there are three standout market-related themes investors should focus on – policy shifts, the rise of China, and sustainability
- The nature of investing in a complex world is that change often happens slowly and then all at once. Our three themes are no different
- A practical means of coping with this slow but uncertain change is by systematically monitoring those themes through thoughtfully-curated data
- With this in mind we have developed three dashboards, which we will keep up to date and evolve over time. They are on the WTW website: [United States](#) [Europe](#) [Hong Kong](#) [Australia](#)

Following a period of strong growth in 2020, Chinese policy support is expected to turn neutral this year. Fiscal deficits and liquidity will be gradually reduced to manage financial and leverage risks



Source: Willis Towers Watson

Investment outlook

Portfolio priorities for 2021

The high-level macroeconomic outlook

- Our economic outlook is split between a period of recovery and subsequent growth. Policy stimulus, in particular the ability to combine extremely easy monetary policy with highly reactive and historically sizeable fiscal stimulus, will determine how long the recovery phase lasts. It will also influence subsequent growth rates, although what ultimately drives this growth (productivity) is subject to a number of complex and overlapping factors.
- This new policy regime is likely to dominate the outcomes for the developed world in aggregate, with important differences between countries. In turn, this will impact market pricing and prospective returns. It also suggests less policy emphasis, relative to the past few decades, will be placed on controlling inflation and more on maximising employment, growth, and possibly the inclusiveness of both.
- Market pricing has generally responded to this policy regime but there remain profound implications for portfolio strategy.



With this outlook in mind, what are the key market-related themes we think investors should focus on to position themselves for success during 2021 and beyond?

We have narrowed down a potentially long list by assessing the risks and opportunities that are both highly material for current portfolio allocations and relatively more certain. From a macroeconomic perspective, we think three themes stand out:

- 1. Policy shifts:** the post-COVID policy regime has shifted in important ways. Whilst much of this shift was evident before 2020, the policy response to the pandemic has accelerated it. This has important implications for return pathways and downside risk management in particular.

- 2. The rise of China:** China's financial system continues to open, which has material and near certain implications for the sources of diversity available to investors and how downside risk can be managed.
- 3. Sustainability:** this encompasses three important topics:
 - a. Climate:** we believe 2021 will prove to be a significant year for the climate transition, with the 26th UN Climate Change Conference of the Parties (COP26) due to take place in November.
 - b. Inclusive growth:** At the same time, the moral imperative to include diverse perspectives, races and life experiences in all spheres of society, including the professional, has been highlighted in 2020. It is also a financial imperative. Our view and hope is that inclusion will become a material influence on investors' choices.
 - c. Stewardship:** in order to manage these imperatives, the need for better practices by governments, regulators, corporates, asset managers, and asset owners is clear and growing.

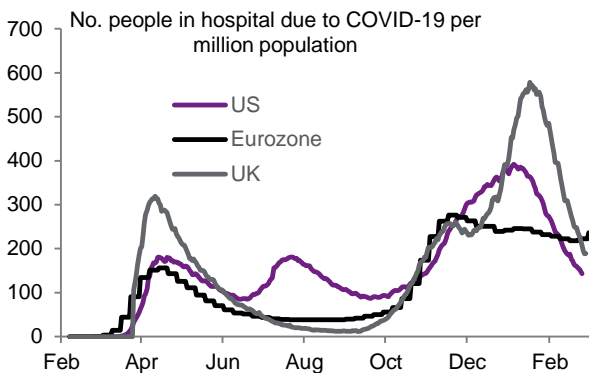
We suggest investors focus on eight key priorities in 2021

- Position for stronger near-term asset returns and lower long-term returns
- Revisit unlisted asset exposure
- Build a balanced exposure to China
- Maintain but evolve downside hedges
- Integrate climate risks & opportunities into portfolio construction
- Embedding inclusion and diversity in all levels of portfolio decision making
- Increase active management
- Monitor macro change

Economic conditions monitor

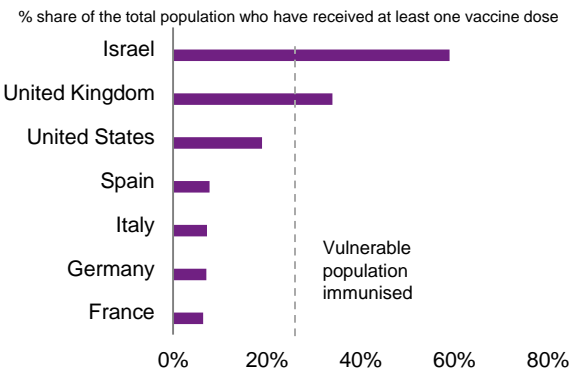
Tracking economic activity in the major economies

Exhibit 1: The number of COVID-19 related hospitalisations have fallen notably in the US and UK



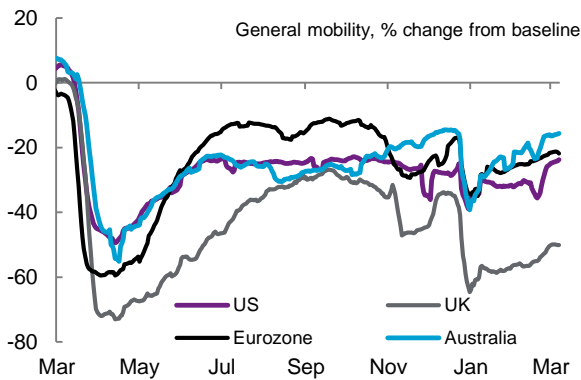
Source: FactSet, Willis Towers Watson

Exhibit 2: The pace of vaccine rollout is crucial to when economies can start to “normalise”



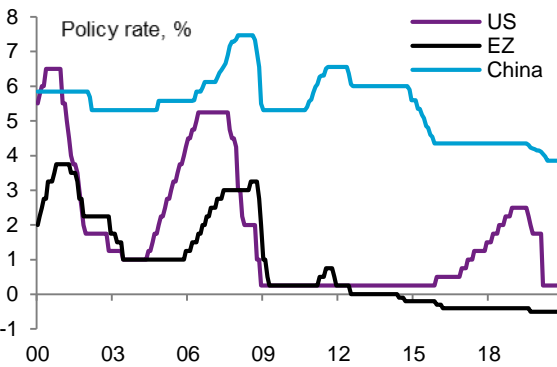
Source: FactSet, Willis Towers Watson

Exhibit 3: Restrictions on mobility are less stringent than last year – but have curbed short-term activity



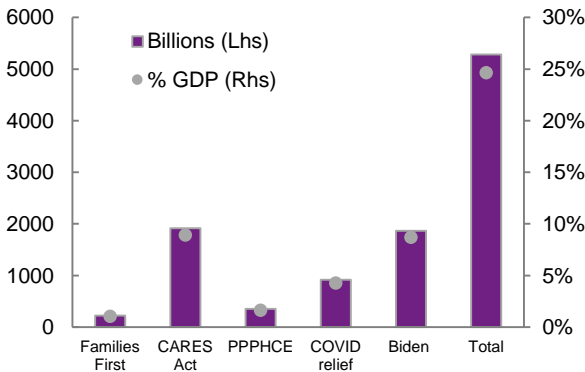
Source: FactSet, Willis Towers Watson

Exhibit 4: We expect US and EZ policy rates to remain at their current levels until at least 2023



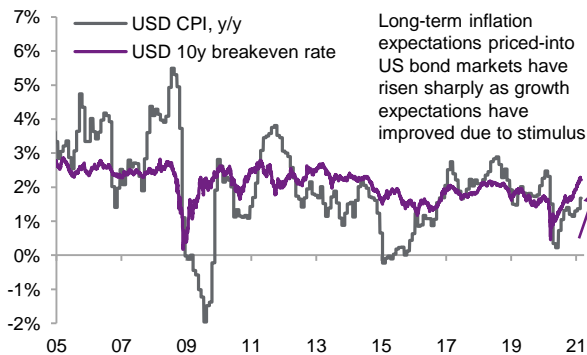
Source: FactSet, Willis Towers Watson

Exhibit 5: US has spent \$5.3tn in fiscal support since the pandemic start – the largest response globally



Source: FactSet, Oxford Economics, Willis Towers Watson

Exhibit 6: The vaccine roll-out and policy support has driven rising growth/inflation expectations in the US



Source: FactSet, Willis Towers Watson

Tracking recent asset price moves and our outlook

Summary: government bonds

Changes to market pricing (government bond yields)

26 February 2021

26 February 2021 % / %pts		Spot yields					What's discounted		
		Level	Δ 1m	Δ 3m	Δ 1y	Δ 3y	1y fwd	2y fwd	5y fwd
Developed nominal yields	Eurozone								
	1y/cash	-0.62	0.07	0.10	0.10	-0.06	-0.69	-0.67	-0.23
	5y	-0.59	0.20	0.19	0.22	-0.59	-0.51	-0.39	0.03
	10y	-0.28	0.27	0.29	0.30	-0.95	-0.19	-0.08	0.20
	US								
	1y/cash	0.02	-0.01	-0.04	-1.00	-2.05	0.43	0.86	1.86
	5y	0.85	0.25	0.36	-0.12	-1.82	1.20	1.53	2.19
	10y	1.50	0.42	0.64	0.34	-1.39	1.76	1.97	2.39
Breakeven infl.	US (CPI)								
	3y	2.29	0.05	0.75	1.08	0.16	-	-	2.07
	5y	2.25	0.02	0.60	0.95	0.12	-	-	2.10
	10y	2.21	0.05	0.49	0.85	0.09	-	-	2.11

A summary of our assessment of government bond pricing and prospective medium-term outcomes

Sovereign bonds	Asset return outlook	Comments
Developed short interest rates		• Across major developed markets, guidance from policymakers remains accommodative. Benchmark rates are at or near perceived lower bounds and central banks are engaged in asset purchases.
US		
UK		• Priced-in short rates have picked up materially year-to-date, consistent with improving expectations for economic conditions. However, this is largely due to rising bond risk premiums and we expect cash rates to remain low as policymakers wait for inflation above target before tightening.
AAA-Eurozone		
Developed 10-year nominal bonds		• As optimism around the economic recovery has grown, intermediate bond yields have risen in recent months. US 10-year rates are c. 70bps higher than January.
US	↑	• Yields are now approaching levels they were trading at before the pandemic struck and are priced to rise further over the next few years.
UK	↑	• Near term, we think that risks to yields are still skewed upwards. Stimulus measures, excess savings, pent up demand and base effects could elevate inflation concerns.
AAA-Eurozone		• We think that risks are more balanced over the medium term. Fiscal stimulus will roll-off in future years, while structural forces, such as high corporate debt levels and demographics, are also likely to constrain the future level of bond yields

Key: Highly negative Negative Neutral Positive Highly positive

US yields have risen sharply YTD. Upside risks to yields remain, but pricing is credible over the medium-term

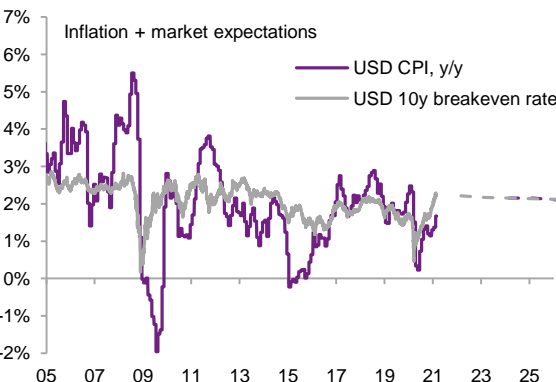
US cash rate and 10y nominal bond yield



Source: FactSet, Willis Towers Watson

US breakeven inflation rates are roughly in line with the mid-point of the Fed's average inflation mandate

US CPI inflation rate and inflation market pricing



Source: FactSet, Willis Towers Watson

Tracking recent asset price moves and our outlook

Summary: credit

Changes to market pricing (credit spreads)

26 February 2021

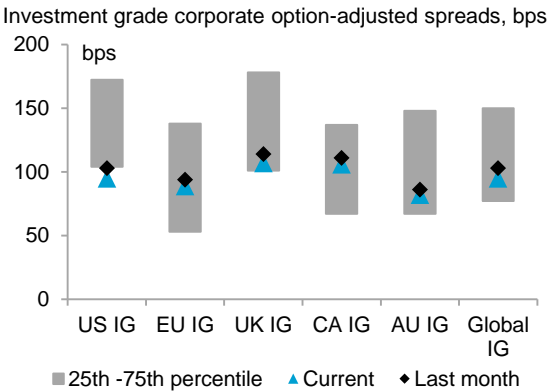
26 February 2021		Pricing - Option adjusted spreads, bps					Implied defaults				
		Current	Δ1m	Δ3m	Δ1y	Δ3y	Current	Δ1m	Δ3m	Δ1y	Δ3y
High grade	Global	95	-8	-15	-32	-2	-0.1%	-0.2%	-0.4%	-0.8%	-0.1%
	US	95	-8	-17	-36	-6	-0.1%	-0.2%	-0.4%	-0.9%	-0.2%
	Eurozone	89	-5	-5	-25	8	-0.3%	-0.1%	-0.1%	-0.6%	0.2%
	UK	107	-7	-12	-36	-20	0.2%	-0.2%	-0.3%	-0.9%	-0.5%
	Canada	106	-5	-19	-11	3	0.2%	-0.1%	-0.5%	-0.3%	0.1%
	Australia	82	-4	-13	-15	-10	-0.5%	-0.1%	-0.3%	-0.4%	-0.3%
Low grade	Global HY	383	-27	-69	-115	45	1.2%	-0.4%	-1.0%	-1.6%	0.6%
	US HY	357	-27	-76	-147	10	0.8%	-0.4%	-1.1%	-2.1%	0.1%
	Eurozone HY	324	-26	-45	-87	38	1.1%	-0.4%	-0.6%	-1.2%	0.5%
	US loans	407	-14	-60	-44	45	1.5%	-0.2%	-0.9%	-0.6%	0.6%
HC EMD	Hc EMD Corps	266	-17	-41	-41	60	2.3%	0.0%	-0.4%	-1.9%	0.9%
	HC EMD Sov	265	0	-21	-94	44	1.5%	-0.3%	-0.6%	-0.6%	0.9%

A summary of our assessment of corporate credit pricing and prospective medium-term outcomes

Credit	Asset return outlook	Comments
Corporate credit		<ul style="list-style-type: none">Investment grade markets are pricing-in an allowance for a below average level of credit losses
Inv. grade		<ul style="list-style-type: none">We expect credit losses to be close to / modestly above these levels, particularly in the nearer term
High yield		<ul style="list-style-type: none">At current spreads, high quality credit assets are approaching levels at which they are likely to provide only moderate returns above equivalent government bonds
US		<ul style="list-style-type: none">We retain a somewhat cautious outlook for developed market speculative-grade credit given shorter-term risks. Current pricing implies a below average level of defaults relative to historic average pricing. As such, pricing has moved somewhat to pricing-in an optimistic outlook for corporate credit
Europe		
Loans		<ul style="list-style-type: none">Niche and securitized market pricing appears to be pricing-in a somewhat more pessimistic outlook in aggregate, relative to traditional corporate credit markets
US		

Key: Highly negative Negative Neutral Positive Highly positive

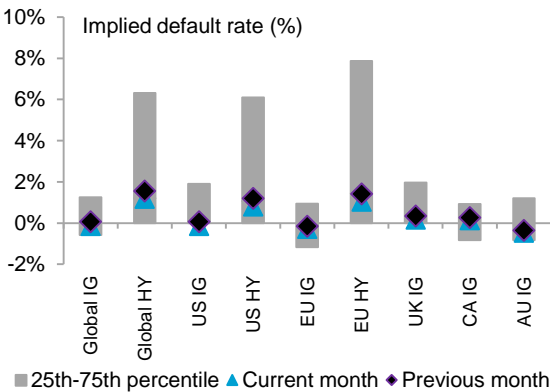
Investment grade spreads contracted modestly over the past month and are broadly at the lower end of their interquartile ranges (excl. EU and Canadian markets)



Source: FactSet, Willis Towers Watson).

Market implied default rates fell modestly over the past month and remain low

Estimated implied default rate based on current pricing



Source: FactSet, Willis Towers Watson).

Tracking recent asset price moves and our outlook

Summary: equity

Changes to market pricing (equity)

26 February 2021

26 February 2021	Δ 1 month			Δ 1 year				Δ 3 years (pa)		
	Total return	EPS	Trailing P/E	Price return	Total return	EPS	Trailing P/E	Total return	EPS	Trailing P/E
Canada	2.0%	2.2%	-0.4%	4.8%	8.4%	-31.6%	53.2%	7.9%	-9.2%	15.1%
Eurozone	1.3%	-1.5%	2.5%	2.1%	4.5%	-30.7%	64.6%	4.3%	-17.8%	23.0%
Japan	1.0%	9.4%	-7.7%	17.0%	19.9%	-28.1%	62.7%	5.5%	-12.1%	17.2%
UK	-2.1%	10.7%	-11.9%	-9.4%	-6.3%	-54.9%	100.7%	-0.5%	-25.8%	28.6%
US	-0.9%	0.2%	-1.3%	24.9%	27.1%	-17.9%	52.3%	15.0%	0.3%	12.5%
China	-5.6%	-0.9%	-5.0%	36.1%	38.6%	-24.3%	67.6%	9.1%	-3.0%	11.4%
MSCI World	-0.6%	1.2%	-2.2%	17.4%	19.9%	-23.7%	58.3%	11.4%	-6.0%	15.6%
MSCI EM	-3.0%	5.5%	-8.6%	27.4%	30.7%	-19.2%	58.8%	9.3%	-8.9%	13.9%

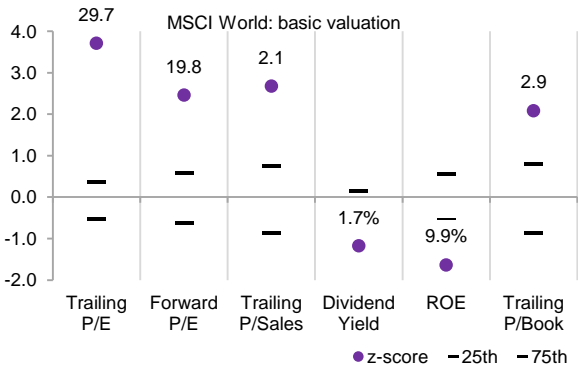
A summary of our assessment of equity pricing and prospective medium-term outcomes

Global equities	Asset return outlook
Developed	
Emerging	
Comments	
<ul style="list-style-type: none">Price to Earnings ratios have risen sharply over the last year and are high, as investors look through the trough in earnings that has been caused by COVID related mobility restrictionsWe have seen a material earnings recession in world equity markets but expect a subsequent recovery in 2021 – the pace of recovery in each country will depend heavily on the effectiveness of fiscal/ monetary policy responsesUS valuations are higher relative to broader developed markets, which we see as consistent with higher US fiscal and monetary stimulus. The impact of sharply rising US bond yields on US equity valuations and returns has been negative but small over the last month, rather than disruptiveEM valuations are lower vs. developed markets, which we see as consistent with higher short-term virus and economic related risksCurrent equity prices are consistent with good expected 5-year returns in a scenario where earnings recover quickly in 2021. This is contingent on effective policy, with drawdown risk and uncertainty remaining	

Key: Highly negative Negative Neutral Positive Highly positive

Basic developed market financial ratios are high as investors expect medium term earnings potential to remain relatively unimpacted

Valuation metrics for the MSCI World equity index



Source: FactSet, Willis Towers Watson).

Our valuation metric, which estimates the future sales growth that is priced-into equity markets is broadly in-line with the last decade – US equities are not expensive

Medium-term growth priced-in by the US equity price, % pa



Source: FactSet, Willis Towers Watson).

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